NATIONAL TEA CO.

ANNUAL REPORT 1965

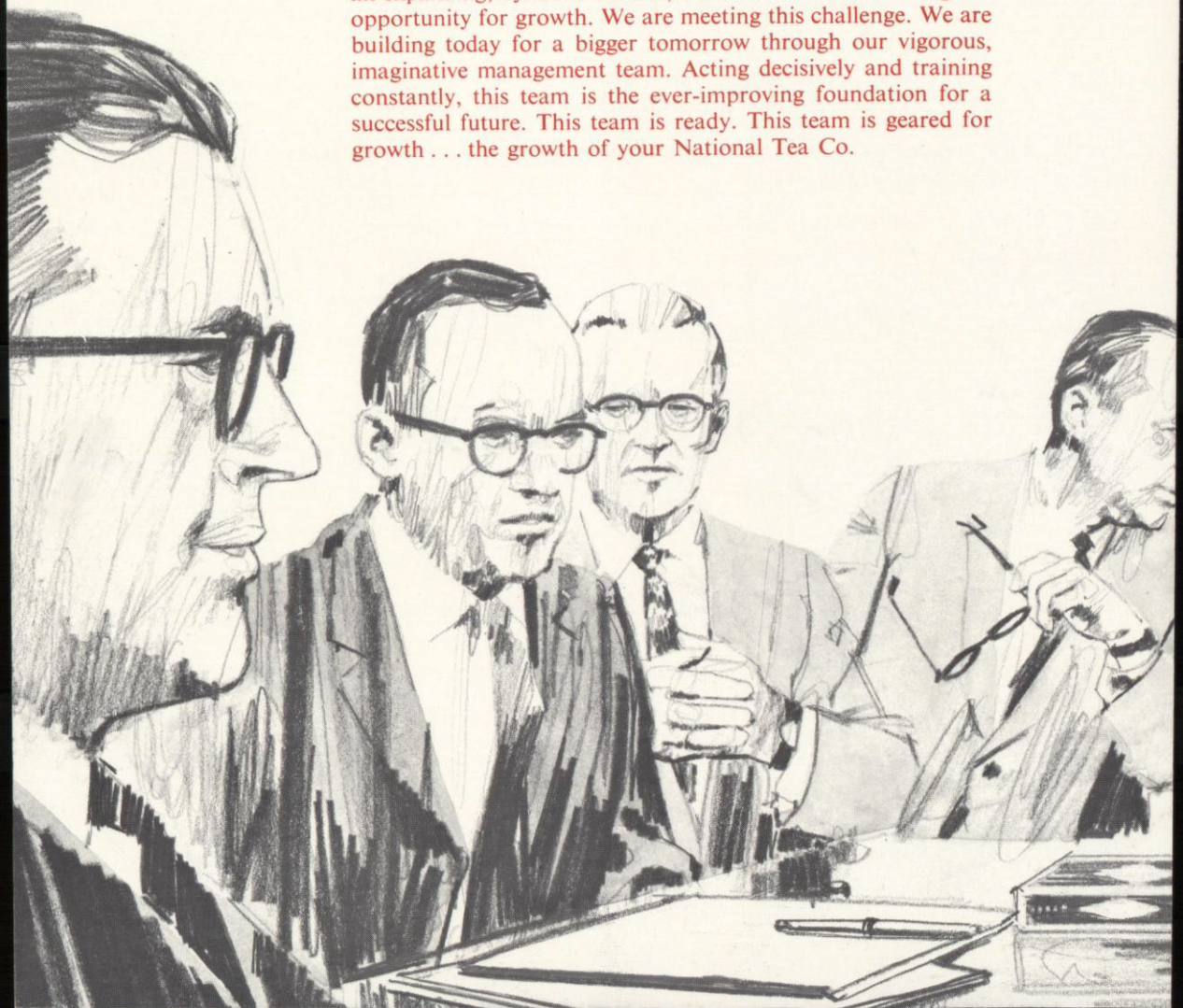
GROWING WITH A GROWING AMERICA

GEORGE C. METCALF
Chairman of the Company

NORMAN A. STEPELTON
President and Chief Executive Officer

A management team geared for growth

America is on the move. Today's young, growing families form an expanding, dynamic market, a market that offers us a great opportunity for growth. We are meeting this challenge. We are building today for a bigger tomorrow through our vigorous, imaginative management team. Acting decisively and training constantly, this team is the ever-improving foundation for a successful future. This team is ready. This team is geared for growth . . . the growth of your National Tea Co.



Directors

NORBERT L. CHAPLICKI
Executive Vice President

JOHN F. CUNEO
President of The Cuneo Press, Inc.

EDWARD L. JONES
Secretary of George Weston Limited

RICHARD G. MEECH
Vice President, Secretary and Treasurer of Loblaw Groceterias Co., Limited

GEORGE C. METCALF
Chairman of the Company and President of Loblaw Groceterias Co., Limited

W. STRUAN ROBERTSON
Partner, Borden, Elliot, Kelly and Palmer

NORMAN A. STEPELTON
President and Chief Executive Officer

CLAUDE H. WEBSTER
Executive Vice President

W. GARFIELD WESTON
Chairman of the Board of George Weston Limited

Officers

GEORGE C. METCALF
Chairman of the Company

NORMAN A. STEPELTON
President and Chief Executive Officer

Executive Vice Presidents

CLAUDE H. WEBSTER
Operations

NORBERT L. CHAPLICKI
Administration

Vice Presidents

GEORGE E. HOUSTON
Regional Operations

J. E. LAUGHLIN
Regional Operations

FRANK E. LINQUIST
Regional Operations

GORDON A. SEEBERG
Merchandising

WILLIAM H. LOWMAN
Meat Operations

HAROLD L. WILKENS
Produce Operations

ROBERT S. KLEGON
Drug Operations

H. L. MARTIN
Personnel

WILLIAM J. LEDERER
General Counsel

J. P. QUIRK
Labor Relations

G. W. MAXWELL
Real Estate

JAMES E. COLLOTON
Warehousing & Transportation

ROBERT E. SWAIN
Store Planning & Equipment

NAT MALT
Division Manager

RODGERS N. BROWN
Division Manager

Secretary-Treasurer
ALLAN WILSON, JR.

Comptroller
E. C. WINLAND

HOME OFFICE • 1000 N. Crosby Street, Chicago, Illinois 60610
Divisional Offices and Warehouses • Chicago • Minneapolis • Milwaukee • Indianapolis
Detroit • St. Louis • New Orleans • Memphis • Davenport • Denver • Sioux City • Youngstown

Financial Highlights

FOR THE FISCAL YEAR ENDED:	January 1, 1966	January 2, 1965 (53 weeks)	December 28, 1963	December 29, 1962	December 30, 1961
Sales	$1,161,948,193	$1,122,515,806	$1,056,919,339	$979,049,258	$888,852,905
Income before Federal income taxes	19,891,190	20,346,294	16,890,546	18,123,011	19,464,514
Federal income taxes	8,575,000	9,706,000	8,526,000	9,005,000	10,150,000
Special credit, net of taxes	—	—	840,710	—	—
Net income and special credit	$ 11,316,190	$ 10,640,294	$ 9,205,256	$ 9,118,011	$ 9,314,514
Percent to sales	.97%	.95%	.87%	.93%	1.05%
Per share*	1.32	1.25	1.17	1.28	1.31
Dividends per share	.80	.80	.80	.80	.80
AT YEAR END:					
Working capital	$ 63,031,103	$ 61,729,199	$ 57,425,117	$ 58,550,701	$ 42,422,922
Property and equipment	93,481,743	92,987,098	94,905,503	92,242,459	76,703,420
Long-term debt	25,380,901	30,905,630	32,531,023	33,607,132	29,628,922
Shareholders' investment	126,659,444	119,227,040	116,159,100	113,783,457	87,039,714
Shares outstanding	8,631,976	8,483,152	8,525,815	7,161,942	7,133,505
Book value per share	14.67	14.05	13.62	13.35	12.20
Supermarkets in operation	941	973	986	985	897

*Based upon average of number of shares outstanding at beginning and end of year.

President's Letter

To Our Shareholders:

Sales and earnings of National Tea Co. in 1965 were the highest in your Company's history and reflect continuing progress in all major phases of operations.

Sales and Earnings

Sales for 52 weeks ended January 1, 1966, reached $1,161,948,193, an increase of 3.5 per cent from $1,122,515,806 recorded in the previous 53-week year. Eliminating the 53rd week last year, the improvement in sales amounted to 5.5 per cent, and was achieved with 32 fewer stores in operation by the end of 1965.

Net income rose 6.4 per cent to $11,316,190, equal to $1.32 per share, from $10,640,294, or $1.25 per share for fiscal 1964. Earnings per share are based on an average of 8,558,000 Common Shares outstanding in 1965, an increase of 54,000 shares over the preceding year.

In the last five years, sales have shown a 35.8 per cent rise from $855,840,888 in 1960, while net earnings have increased 30.6 per cent from $8,661,825.

Operations

During the past five years, your Company has effected significant improvements in operations, particularly in supermarket physical facilities.

In 1960, average annual volume per store was $947,232 and the average size for 897 stores was 12,763 square feet. At the close of the last fiscal year, National Tea Co. had 941 stores in operation. Average annual volume per store was $1,202,864 and the average size was 13,749 square feet.

Capital Improvements

Of the 941 stores now in operation, 365 were opened and 258 underwent major remodeling during the last five years.

Concurrently, your Company increased and expanded its service and warehouse facilities. Distribution centers were completed in New Orleans and St. Louis, and a frozen food warehouse was constructed in Chicago. The Milwaukee warehouse was enlarged substantially and meat commissaries and produce coolers were installed or enlarged in other warehouses.

Other additions in the five year period included a larger and more modern bakery in Milwaukee, a regional health and beauty aid warehouse in Chicago, a produce packaging plant in the Chicago area, together with improvements or replacements of plant and transportation equipment to increase efficiency and provide greater flexibility.

Improvements to Properties in 1965

During the last year, 35 new or relocated stores were added and 67 older stores were closed. Four stores severely damaged by fire or tornadoes will be replaced in 1966. Average size of stores added in 1965 was 16,338 square feet.

During the year, 60 stores were remodeled at a cost in excess of $2,600,000. Included in this total were eight stores enlarged to serve customers more adequately in areas where our sales potential had outstripped existing facilities.

The Company's capital investment program, including new and relocated stores, store remodelings, warehouse, transportation and office replacements and additions totaled $14,069,664, excluding the cost of the new St. Louis distribution center, which was financed through an affiliated real estate corporation.

Personnel Development

One of the strengths of the Company is the ability of its personnel which we believe ranks with the finest in the entire food marketing industry. Vigorous competition coupled with day-to-day fluctuations in local market conditions demand decentralized management with autonomy to respond and cope with rapid changes promptly. To this end, the Company's organizational program has been developed in two ways: (1) providing personnel with specialized skills to assist division managers upon request, and (2) training personnel at all echelons in the principles of our business.

Drug Department Operations

Another important phase of our program of internal growth is the expansion of the merchandising of health and beauty aids and

pharmaceuticals. Up to the year 1965, this had taken the form of enlarging our store health and beauty aid departments to meet the increased demand for these products in our stores, installation of a limited number of pharmacy departments in selected divisions, and warehousing of these items. These programs were continued and expanded in 1965, with emphasis on three projects: (1) establishment of a regional health and beauty aid warehouse in Chicago, (2) upgrading expanded health and beauty aid departments to complete drug departments which now carry the newly-established identification *Kare Drugs*, and (3) opening of combination, one-stop National Food-Kare Drug shopping centers.

At year end, there were 25 complete drug departments in operation. It is anticipated that an additional 19 Kare Drug departments or separate stores will be opened in 1966.

Organizational Changes

To keep pace with the growth and increasing complexity of our business, several organizational changes were made during the year.

Mr. N. L. Chaplicki was elected to the newly-created post of Executive Vice President-Administration. Mr. C. H. Webster continues as Executive Vice President-Operations.

Mr. W. Lowman was elected Vice President-Meat Operations.

In recognition of the growing importance of several areas of specialized activity, the following were elected Vice Presidents in charge of their respective activities: Mr. J. E. Colloton, Warehousing and Transportation, Mr. R. S. Klegon, Drug Operations, Mr. G. W. Maxwell, Real Estate Operations, and Mr. R. E. Swain, Store Planning and Equipment.

Financial Position

The financial position of your Company was strengthened materially during the year. Long-term debt was reduced $5,524,729 to $25,380,901 by repayments and by conversion of Convertible Debentures. The conversion privilege on the 3½% Subordinated Debentures expired during 1965. Working capital increased slightly and the current ratio as defined under the indenture securing the 5% Sinking Fund Debentures, which requires a minimum ratio of 2 to 1, was 2.3 to 1.

Tribute to Our Employees

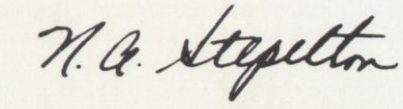
We are extremely proud to report to you several instances in which the dedication and abilities of employees were dramatically displayed during the year. Despite almost complete disruption of communications after Hurricane Betsy struck 38 of our stores in the New Orleans area on September 10, our people carried on store operations as long as possible. They did everything possible to continue to serve the community, safeguard the stores, equipment and merchandise during the storm and acted swiftly to resume business after the hurricane had passed.

Even though their homes were lost or badly damaged, our employees gave first priority to the job of getting food distributed in the disaster area, thereby making many new friends for National Tea Co. in the process.

We found this same spirit of dedication among our Denver employees when a flood in that area last June all but swept away our packing plant. To them, and to all of our employees, we express our thanks for their loyalty and their contributions which have made possible the achievements of the past years.

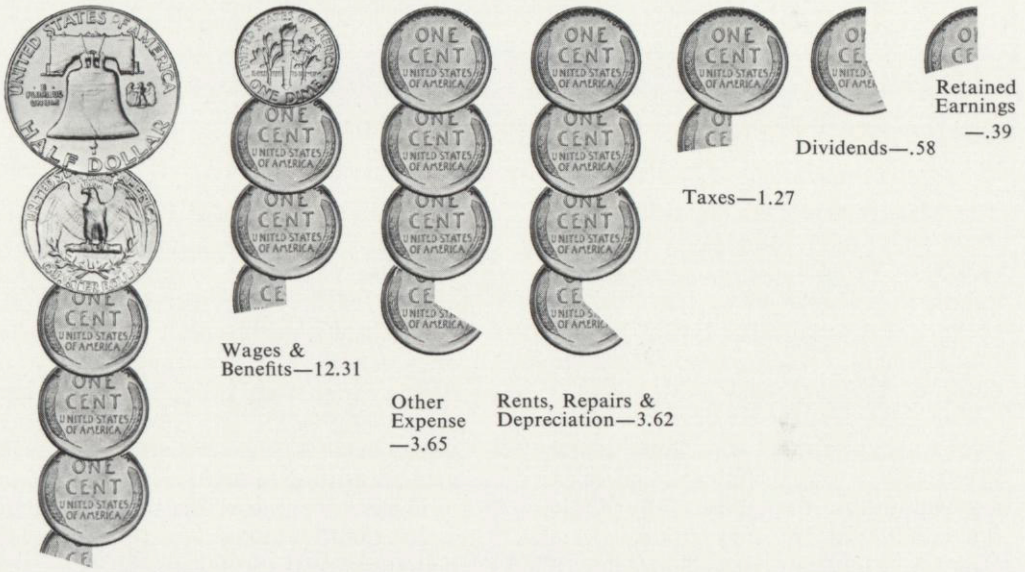
Outlook

As we move into 1966, we sincerely believe that we have a firm foundation on which to grow. With the plans that have been made, and with our experienced and well qualified personnel, we can look forward with optimism to a year of improved profits. The year 1966 will be another year of growth . . . continued growth with a growing America.



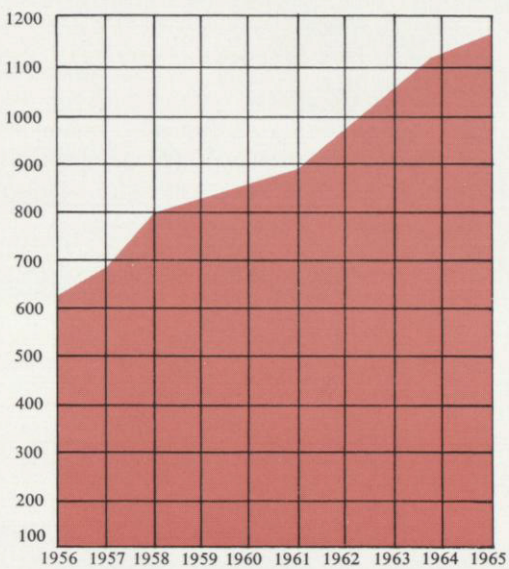
President

Chicago, Illinois
February 11, 1966

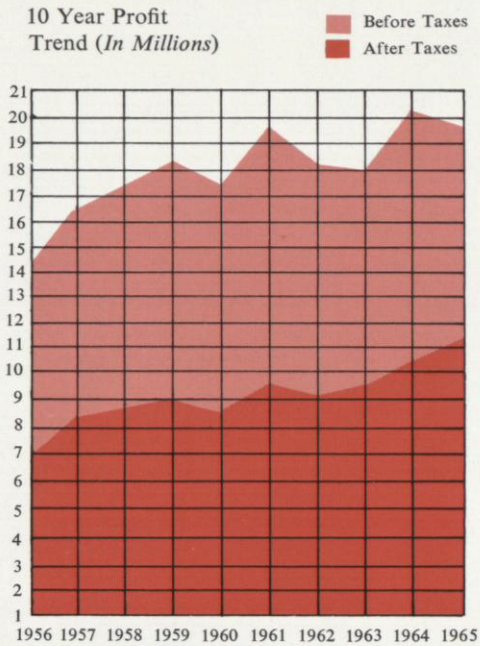


1965 Distribution of the Sales Dollar

10 Years of Record Sales (*In Millions*)



10 Year Profit Trend (*In Millions*)



Forward-Looking Management in Action

The Management Development Program. Building a solid foundation for growth requires a progressive management team. Leadership, know-how, imagination—these are the qualities the National Management Development Program is designed to teach and cultivate.

Candidates for the program are selected from those personnel who show the most talent and potential under actual operating conditions. Expert teaching is given the candidates in such courses as the Grocery Merchandising Workshop, the Accounting Workshop, the Dairy Clinic and the Cashier-Bookkeeper's School.

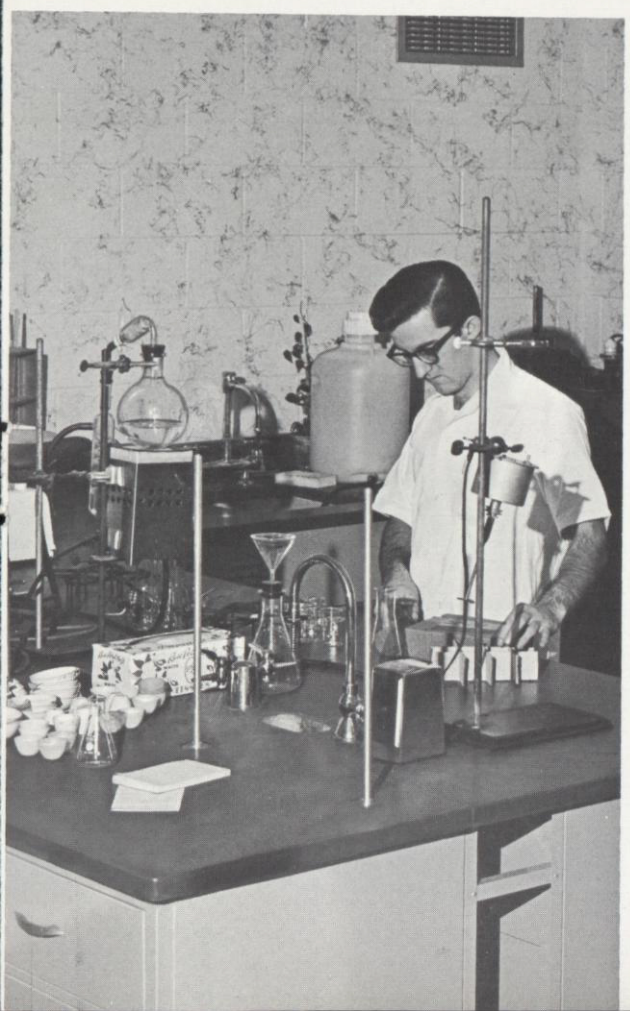
To strengthen the foundation for growth, college education in Food Distribution is offered to highly promising employees through National's Scholarship Program. Choosing either Michigan State or Cornell, the candidate enters the nation's best study programs in the supermarketing field. The young graduates bring back a high potential for future growth with National.

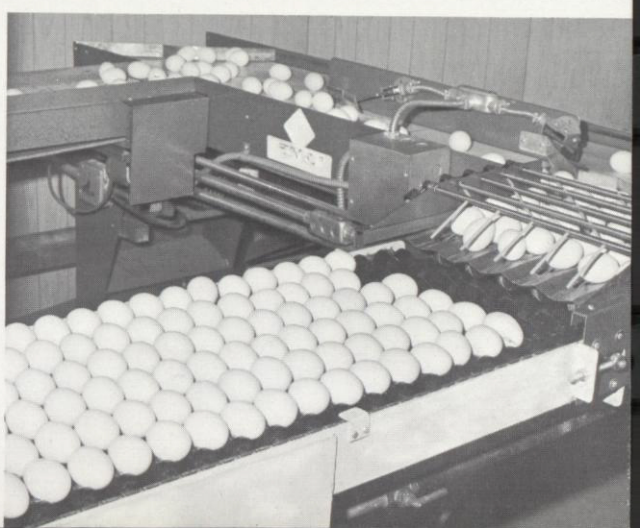
These are some of the many ways that a youthful, aggressive and educated management team is formed. This is the foundation for the future. This is growth in the making.

Research and Development

New Food Quality Control Laboratory. To assure highest food quality in both National's own brands and all others, a new quality control laboratory has been built in Chicago. Here food technologists, microbiologists and chemists check and double-check food quality. As part of management's never-ceasing efforts to build greater customer loyalty and satisfaction, this new laboratory is a scientific stepping stone toward future growth . . . one more way your research-oriented management is building today for a bigger tomorrow.

New ways with Automation. Typical of management's striving for new techniques are the arrangements made for the study of automated egg production. Called "Egg-O-Mat," this Pilot Model production facility automatically gathers, washes, candles and grades nearly 2,500 dozen eggs produced daily by the "Egg-O-Mat's" 43,000 hens. This advance in farm-to-housewife marketing allows finest quality eggs to reach participating National Tea Co. Stores within 48 hours after they are laid. Newer, better methods of operation are a constantly sought goal.





1965 Consolidated Balance Sheet

Assets

	January 1, 1966	January 2, 1965
CURRENT ASSETS:		
Cash	$ 13,174,939	$ 15,936,311
Accounts receivable	6,774,915	8,011,763
Inventories, at lower of average cost or market	90,503,841	82,195,058
Prepaid expenses, etc.	4,999,126	5,303,102
Real estate in process of development and sale	2,098,563	1,680,989
Total current assets	$117,551,384	$113,127,223
OTHER ASSETS	$ 1,563,499	$ 1,691,373
PROPERTY AND EQUIPMENT, at cost:		
Land	$ 2,902,201	$ 2,778,421
Buildings	10,197,624	9,384,471
Fixtures and equipment	111,645,273	108,325,841
Reserves for depreciation	(54,415,562)	(51,003,497)
Leasehold improvements, less amortization	22,223,415	22,573,070
	$ 92,552,951	$ 92,058,306
Unamortized excess of cost of investment in divisions and subsidiaries over underlying book values at dates of acquisition	928,792	928,792
	$ 93,481,743	$ 92,987,098
	$212,596,626	$207,805,694

The accompanying notes are

National Tea Co. & Subsidiaries

Liabilities

	January 1, 1966	January 2, 1965
CURRENT LIABILITIES:		
Current maturities of long-term debt	$ 1,566,000	$ 1,566,000
Accounts payable	42,817,300	37,098,798
Accrued liabilities	7,907,074	8,339,602
Federal income taxes	2,229,907	4,393,624
Total current liabilities	$ 54,520,281	$ 51,398,024
LONG-TERM DEBT:		
Installment mortgage notes on store buildings	$ 697,901	$ 914,630
3½% promissory notes, due serially to 1969	258,000	344,000
4% promissory notes, due serially to 1973	8,800,000	9,800,000
5% sinking fund debentures, due 1977	8,160,000	8,640,000
4¾% term note, due 1967	5,000,000	5,000,000
3½% subordinated debentures, due 1980	2,465,000	6,207,000
	$ 25,380,901	$ 30,905,630
OTHER LIABILITIES:		
Deferred Federal income taxes	$ 5,646,000	$ 5,885,000
Self-insurance	390,000	390,000
	$ 6,036,000	$ 6,275,000
SHAREHOLDERS' INVESTMENT:		
Common shares, $4 par value, authorized 10,000,000 shares; issued 8,750,413 shares (8,527,952 in 1964)	$ 35,001,652	$ 34,111,808
Paid-in surplus	30,761,001	27,528,610
Earned surplus	62,919,888	58,378,000
	$128,682,541	$120,018,418
Less cost of 118,437 common shares in treasury (44,800 in 1964)	2,023,097	791,378
	$126,659,444	$119,227,040
	$212,596,626	$207,805,694

an integral part of this statement.

Statements of Consolidated Income and Surplus

	FISCAL YEAR ENDED	
	January 1, 1966 (*52 weeks*)	January 2, 1965 (*53 weeks*)
INCOME:		
SALES	$1,161,948,193	$1,122,515,806
COSTS AND EXPENSES:		
Cost of sales, occupancy, buying and other operating expenses	$1,008,331,891	$ 973,917,130
Selling, general and administrative expenses	131,813,343	126,163,669
Interest	1,315,769	1,467,713
Profit sharing	596,000	621,000
Federal income taxes	8,575,000	9,706,000
	$1,150,632,003	$1,111,875,512
NET INCOME	$ 11,316,190	$ 10,640,294

EARNED SURPLUS:	
BALANCE AT JANUARY 2, 1965	$ 58,378,000
ADD (DEDUCT):	
Net income	11,316,190
Dividends ($.80 per share)	(6,774,302)
BALANCE AT JANUARY 1, 1966	$ 62,919,888

PAID-IN SURPLUS:	
BALANCE AT JANUARY 2, 1965	$ 27,528,610
Excess of principal amount of debentures retired over par value of common shares issued in conversion	2,959,371
Excess of proceeds over par value of common shares sold to officers and employees under stock option plans	273,020
BALANCE AT JANUARY 1, 1966	$ 30,761,001

The accompanying notes are an integral part of these statements.

Consolidated Statement of Source and Disposition of Funds

	FISCAL YEAR ENDED	
	January 1, 1966 (*52 weeks*)	January 2, 1965 (*53 weeks*)
SOURCE OF FUNDS:		
Net income	$11,316,190	$10,640,294
Non-cash items deducted in arriving at net income:		
Depreciation and amortization	13,575,019	13,052,907
Increase in reserve for self-insurance	—	140,000
Deferred Federal income taxes	51,000	233,000
Total funds from earnings	$24,942,209	$24,066,201
Proceeds from sale of common shares to optionees	381,580	29,937
Other sources, net	126,529	572,122
Total	$25,450,318	$24,668,260
DISPOSITION OF FUNDS:		
Cash dividends to shareholders	$ 6,774,302	$ 6,812,905
Net additions to property and equipment	14,069,664	11,134,502
Retirement of long-term debt	5,524,729	1,625,393
Less conversion of 3½% debentures	(3,742,000)	—
Acquisition of treasury shares	1,231,719	791,378
Transfer from deferred to current income tax reserves	290,000	—
Increase in working capital	1,301,904	4,304,082
Total	$25,450,318	$24,668,260

The accompanying notes are an integral part of this statement.

Notes to Consolidated Financial Statements

Long-Term Debt

Aggregate maturities and sinking fund requirements under long-term loan agreements, exclusive of minor installments due on store building mortgage loans are $1,566,000 in 1966, $6,566,000 in 1967, $1,566,000 in 1968 and 1969, and $1,480,000 in 1970.

Dividend Restriction

Under the terms of the indenture securing the 5% Sinking Fund Debentures, $25,721,728 of earned surplus is restricted as to the payment of cash dividends on and the purchase of common shares at January 1, 1966. In addition the company must maintain a current ratio of consolidated current assets to consolidated current liabilities as defined in the indenture of at least 2 to 1. As of January 1, 1966, the current ratio as defined was 2.3 to 1.

Stock Options

As of January 1, 1966, there were 66,680 unissued common shares reserved for options. All of such options were exercisable at that date at prices ranging from $13.875 to $16.74 per share. Each option under the Plan expires four years after date of grant, but not later than January 1, 1968. These options may be exercised in whole or in part at any time from eighteen months following the date of grant until expiration of the option.

Legal Proceedings

In March, 1959, the Federal Trade Commission filed a complaint against the company alleging that several acquisitions of additional retail grocery stores violated Section 5 of the Federal Trade Commission Act and Section 7 of the Clayton Act. On April 8, 1963, the Hearing Examiner filed his initial decision dismissing the complaint. Such decision was appealed to the full Commission, and on June 10, 1965, the case was re-argued before the Commission at its request. Nothing has occurred in the proceeding to date to indicate that there will be any adverse effect on the company as a result of this complaint.

Lease Commitments

At January 1, 1966, the company and its subsidiaries had 731 leases expiring more than three years after that date (some of which contain percentage rental clauses) with minimum annual rentals amounting to approximately $18,600,000 exclusive of taxes, insurance and maintenance payable by the lessee. Of this amount, approximately 56% applies to leases expiring within 10 years.

Auditors' Opinion

ARTHUR ANDERSEN & CO.

69 West Washington Street

Chicago, Illinois 60602

TO THE SHAREHOLDERS,
NATIONAL TEA CO.:

We have examined the consolidated balance sheet of NATIONAL TEA CO. (an Illinois corporation) AND SUBSIDIARIES as of January 1, 1966, and the related statements of consolidated income and surplus and source and disposition of funds for the fifty-two weeks then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated balance sheet, statements of consolidated income and surplus and source and disposition of funds present fairly the financial position of National Tea Co. and Subsidiaries as of January 1, 1966, and the results of their operations and the sources and disposition of funds for the fifty-two weeks then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding fifty-three week period.

ARTHUR ANDERSEN & CO.

Chicago, Illinois
February 11, 1966

Growth Trend Continues Despite Weather Damage

Neither Hurricane Betsy in the New Orleans area, floods in the Denver area, nor tornadoes in the Illinois and Minnesota areas, interrupted the growth and progress of your National Tea Co. Damaged facilities were, or are now being, replaced with the most modern supermarkets.

The Company is very proud of the fact that, in spite of these severe weather losses, results for 1965 exceeded those of 1964. This indeed reflects the continuing growth trends, the continuing growth *attitude* of your National Tea Co. and its management team.

TRANSFER AGENTS • The First National Bank of Chicago, Chicago, Illinois
The Chase Manhattan Bank, New York, New York
REGISTRARS • Continental Illinois National Bank & Trust Company of Chicago, Chicago, Illinois
Chemical Bank New York Trust Company, New York, New York
TRANSFER AND PAYING AGENTS • 3½% Debentures, Chemical Bank New York Trust Company New York, New York • 5% Debentures, Morgan Guaranty Trust Company, New York, New York

NATIONAL TEA CO.

ANNUAL REPORT 1965